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BEFORE THE PUBLIC UTILITIES COMMISSION

OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Los Angeles District to increase revenues by $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009	A.06-01-005

REPLY COMMENTS OF CALIFORNIA-AMERICAN WATER COMPANY ON THE ALTERNATE PROPOSED DECISION OF COMMISSIONER PEEVEY

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Dated: August 20, 2007

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Application of California-American Water Company (U 210 W) for an order authorizing it to increase its rates for water service in its Los Angeles District to increase revenues by $2,020,466 or 10.88% in the year 2007; $634,659 or 3.08% in the year 2008; and $666,422 or 3.14% in the year 2009	A.06-01-005

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I. INTRODUCTION

Pursuant to Rule 14.3(d) of the Rules of Practice and Procedure of the California Public Utilities Commission ("CPUC"), California-American Water Company ("California American Water") hereby submits its reply comments on the *Alternate Proposed Decision of Commissioner Peevey*, mailed July 24, 2007 ("AD"). As California American Water stated in its opening comments, the AD is far superior to the *Proposed Decision of Administrative Law Judge Walwyn*, mailed May 7, 2007 ("PD").

California American Water supports the AD's recommendation to develop a conservation loss adjustment mechanism ("CLAM"), in particular because it would not necessitate an adjustment to California American Water's return on equity ("ROE"). As noted in its opening comments, however, California American Water is dismayed that the AD adopted the PD's flawed ROE analysis and distribution system infrastructure charge ("DSIC") program.

In the interest of efficiency, California American Water will not repeat the arguments made in its opening comments. In its rely comments California American Water will instead: (1) refute the claims of the Division of Ratepayer Advocates ("DRA") that the AD's stated preference for the CLAM amounts to technical and legal error, (2) address DRA's erroneous claim that the CLAM could merit a ROE adjustment, (3) identify portions of the ROE analysis that should be deleted so as not to foreclose the possibility of a risk factor adjustment in the future, and (4) clarify some of the ambiguous language regarding the implementation of the DSIC.

II. DRA'S ALLEGATIONS OF LEGAL AND TECHNICAL ERROR ARE INCORRECT

In its opening comments, DRA contends that the AD's stated preference for the CLAM amount to technical and legal error. This is not true.

A. Technical Error

DRA's technical error argument rests on its claim that the CLAM would either be impossible or time-consuming and expensive to implement. California American Water disagrees. Generally, a comparison of the rate case weather normalized projected consumption to the actual consumption and weather will provide insight as to the changes in water volume sales due to conservation measures. Although the analysis of that comparison would have to be fine-tuned, it is certainly not beyond the capability of the statistical tools traditionally used by the CPUC, as DRA erroneously claims.

Nor would it take the one to two years to implement the CLAM, as projected by DRA. California American Water estimates that it would be able to develop a workable CLAM within months, not years, and urges that it be given the opportunity to do so in Phase 2 of this proceeding. The CLAM as defined in the AD provides a simple, clear solution to water utilities disincentives to encourage conservation and will allow California American Water to implement conservation rates for its Los Angeles District without undue delay. DRA's claims of technical error are without support.

B. Legal Error

DRA's claims of legal error are similarly easily dismissed. First, DRA contends that the AD would deny the parties due process because there has not been an opportunity to review the technical and policy aspects of the CLAM. The AD, however, addresses only the first phase of this proceeding, which focused on the revenue requirement. The second phase of this proceeding will address issues related to rate design and will provide ample opportunity for the parties to consider all aspects of the CLAM.

Second, DRA argues that it would be legal error to for the CPUC to adopt the PD's policy preference for the CLAM, since the CLAM was not discussed in the first phase of this proceeding. Not only does the CPUC have the authority to express a policy preference in this instance, but it has recently done so in a similar case. In D.06-08-017, the CPUC ordered Suburban Water Systems ("Suburban") to file an application for conservation rates and a WRAM consistent with the one adopted for California American Water in D.96-12-005.[1] The underlying record in that proceeding did not address a WRAM at all. Nonetheless, the CPUC was within its authority to express a policy preference to guide Suburban as it prepared its application. Similarly, the CPUC has the authority to express here a policy preference for a CLAM, which will provide guidance for the parties in the second phase of this proceeding.

III. A ROE ADJUSTMENT IS NOT NECESSARY WITH THE CLAM

The AD correctly states if the parties propose a CLAM, "an ROE adjustment would not be necessary."[2] DRA argues, however, that it is currently impossible to determine the effect of a CLAM on ROE and that a CLAM "could merit a modest ROE adjustment."[3] Once again, DRA is incorrect. As defined in the AD, the CLAM limits California American Water's recovery to undercollection of authorized fixed costs due to conservation rate design or other conservation programs.[4] By its very definition, the CLAM would only bring California American Water back to its pre-conservation rate design level of risk, a fact that AD explicitly acknowledges.[5] Since it would not reduce California American Water's current level of risk, there is no way that it could merit a ROE reduction, no matter how modest. DRA's claims regarding ROE are contradicted by the plain language of the AD's CLAM definition.

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[1] D.06-08-017, 2006 Cal. PUC LEXIS 369, *11.
[2] AD, p. 37.
[3] DRA Comments, p. 9.
[4] AD, p. 35.
[5] *Id.*, p. 35, fn. 41.

IV. THE CPUC SHOULD NOT ADOPT ERRORS OR FORECLOSE THE POSSIBILITY OF A FUTURE RISK FACTOR ADJUSTMENT

As California American Water discussed at length in its comments on the AD and the PD, the ROE analysis contained in both is significantly flawed. The PD's ROE analysis, included unchanged in the AD, contains legal and factual errors. Moreover, even if the ROE analysis did not include errors, the conclusions would still be invalid because they fail to take into account California American Water's increased financial risk.

If the CPUC chooses to adopt the 10% ROE set forth in the AD and PD, it should at least remove the most egregious errors. The CPUC should also remove the language in AD (adopted from the PD) that contradicts basic financial theory and that forecloses future consideration of a risk factor adjustment. California American Water sets forth its recommended deletions in <u>Appendix A</u>.

V. THE CPUC SHOULD CLARIFY THE DSIC'S IMPLEMENTATION

As California American Water discussed in its comments on the AD and PD, it believes that its proposed Infrastructure System Replacement Surcharge ("ISRS") program would be better way to meet the CPUC's goals of encouraging infrastructure investment and streamlining the CPUC process than the DSIC program proposed in the AD and PD. Nonetheless, should the CPUC adopt the proposed DSIC program, it should make sure that the language in its decision provides clear guidance for its implementation.

Specifically, the AD states

> In this proceeding we have reviewed and found reasonable for the Los Angeles District a routine infrastructure investment level for the GRC period of 7% of annual revenues. Therefore, we adopt a 7% surcharge cap for this GRC. In dollar terms, this is a $1,323,588 cap for 2007, and will be adjusted for 2008 and 2009 based on revenue escalation factors.[6]

Similar language is used in the Conclusions of Law and Ordering Paragraphs. California American Water is concerned that this language will create confusion because it

[6] AD, p. 50.

appears to state that California American Water can spend 7% of annual revenues (or $1,323,588) in a single year and then spend similar amounts in 2008 and 2009. California American Water does not believe that this is the CPUC's intent. Instead, California American Water suggests setting the DSIC cap for the entire period at 7% of 2007 annual revenues. This means that California American Water would have $1,323,588 to spend on DSIC projects over the entire GRC period and that there would no need to make adjustments in 2008 and 2009. California American Water's suggested revisions are set forth in Appendix B. Additionally, California American Water has attached a sample (hypothetical) surcharge calculation as Appendix C. California American Water recommends that the CPUC attach this to the final decision to provide guidance to the CPUC Water Division

VI. CONCLUSION

The AD represents a significant improvement over the PD. Contrary to DRA's claims, there are no legal or technical errors that would prevent the CPUC from adopting the AD's recommendations regarding the CLAM. California American Water urges the CPUC to adopt the AD, with the modifications suggested in its opening comments. If the CPUC declines to make the modifications suggested in California American Water's opening comments, it should at least make the corrections and clarifications set forth in the attached appendices.

Dated: August 20, 2007

Respectfully submitted,

By:________________________

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Appendix A

AD, pp. 30-31.

~~In Cal-Am's last GRC proceeding, we denied Cal-Am a requested 0.5% leverage adjustment, finding that (a) Cal-Am was not riskier than comparable water utilities, (b) Cal-Am's shareholders are already rewarded for a lower equity ratio through the amortization of the Citizens acquisition premium, and (c) that Cal-Am claimed in the RWE merger proceeding that Commission approval of the merger would provide significant benefits to ratepayers from savings on cost of capital, specifically from increased leverage, and that these benefits would be passed through 100% to ratepayers.~~

~~We find here that the reasons given in D.06-11-050 for denying a leverage adjustment are still applicable.~~ In addition, as discussed earlier in our approval of the Cost of Capital portion of the settlement, the settlement in this proceeding is based on a capital structure that is less leveraged than (1) the company's actual consolidated capital structure, (2) the company's target capital structure, and (3) the projected capital structure contained in Cal-Am's financing application, A.06-05-005.

The recent successful debt offering undertaken by Cal-Am indicates that the capital markets view it quite favorably and are not requiring a premium for financial risk. ~~Cal-Am's chooses to carry a lower common equity ratio, and it does so without adverse effect on the company.~~

In summary, we find that Cal-Am's leverage ratio is within an acceptable range as reflected in S&P credit ratings of its affiliate and parent companies, has not caused investors to demand a higher ROE in comparison to comparable water utilities, ~~provides ratepayer benefits committed to in the RWE merger proceeding,~~ and does not warrant an upward leverage adjustment to the ROE. We deny Cal-Am's request for a leverage adjustment.

Appendix B

AD, p. 50.

In this proceeding we have reviewed and found reasonable for the Los Angeles District a routine infrastructure investment level for the GRC period of 7% of annual revenues. Therefore, we adopt a ~~7%~~ total surcharge cap of 7% of 2007 revenues for this GRC period. In dollar terms, this is a $1,323,588 cap for ~~2007, and will be adjusted for 2008 and 2009 based on revenue escalation factors~~ the GRC period.

AD, p. 64 (Conclusion of Law 8).

a. The surcharge should be based on the infrastructure projects reviewed and approved in this proceeding, identified in the Cal-Am/DRA settlement, and have a total cap of 7% of 2007 annual adopted revenues for the ~~test~~ GRC period. The dollar cap for ~~2007~~ the entire GRC period is $1,323,588~~, and will be adjusted for 2008 and 2009 based on escalation factors~~.

b. Cal-Am should file by quarterly advice letter, under the Tier 3 procedures specified in D.07-01-024, for its DSIC surcharge. The surcharge should be calculated as set forth in the attached example. It should explicitly and clearly state in each advice letter filing, and provide supporting documentation, for (1) any project that was not approved in the GRC proceeding, and (2) any project that is included at an amount over the level authorized in this GRC proceeding.

AD, p. 66, (Ordering Paragraph 4)

a. The surcharge should be based on the infrastructure projects reviewed and approved in this proceeding, identified in the Cal-Am/DRA settlement, and have a total cap of 7% of 2007 annual adopted revenues for the ~~test~~ GRC period. The dollar cap for ~~2007~~ the entire GRC period is $1,323,588~~, and will be adjusted for 2008 and 2009 based on escalation factors~~.

b. Cal-Am should file by quarterly advice letter, under the Tier 3 procedures specified in D.07-01-024, for its DSIC surcharge. <u>The surcharge should be calculated as set forth in the attached example.</u> It should explicitly and clearly state in each advice letter filing, and provide supporting documentation, for (1) any project that was not approved in the GRC proceeding, and (2) any project that is included at an amount over the level authorized in this GRC proceeding.

Appendix C

Sample Surcharge Calculation

CALIFORNIA AMERICAN WATER | Appendix C
LOS ANGELES OPERATING DISTRICT | EFFECTIVE DATE 4/1/2007
INFRASTRUCTURE REPLACEMENT SURCHARGE (ISRS)

STEP ONE - IDENTIFY ISRS-ELIGIBLE NET ADDITIONS

January and February 2007- ELIGIBLE NET ADDITIONS

ACCOUNT NUMBER	DESCRIPTION	ADDITIONS	RETIREMENTS	NET ADDITIONS
315	Wells and Springs	$0	$0	$0
316	Supply Mains	0	0	0
325	Other Pumping Equipment	41,360	0	41,360
332	Water Treatment Equipment	4,000	0	4,000
343.1	Distribution Mains - 4" & Less	0	0	0
343.2	Distribution Mains - 6" to 10"	383,160	1,080	382,080
343.3	Distribution Mains - 12 & Larger	0	0	0
345	Services	78,000	1,838	76,162
346	Meters	30,000	0	30,000
348	Hydrants	4,800	29	4,771
	Totals	$541,320	$2,947	$538,373

STEP TWO - CALCULATE ANNUAL AND MONTHLY DEPRECIATION

ACCOUNT NUMBER	DESCRIPTION	ANNUAL DEPRECIATION RATE	ADDITIONS	DEPRECIATION
315	Wells and Springs	3.02%	$0	$0
316	Supply Mains	2.26%	0	0
325	Other Pumping Equipment	4.98%	41,360	2,060
332	Water Treatment Equipment	6.72%	4,000	269
343.1	Distribution Mains - 4" & Less	3.08%	0	0
343.2	Distribution Mains - 6" to 10"	2.44%	383,160	9,349
343.3	Distribution Mains - 12 & Larger	2.33%	0	0
345	Services	3.05%	78,000	2,379
346	Meters	4.16%	30,000	1,248
348	Hydrants	2.75%	4,800	132
Total Annual Depreciation			$541,320	$15,437
Total Monthly Depreciation				$1,286

STEP THREE - CALCULATE ANNUAL AND MONTHLY AD VALOREM TAXES

ISRS-eligible net additions	$538,373
Ratio of ad valorem taxes to net plant	1.00%
Total additional annual ad valorem taxes	$5,384
Total additional monthly ad valorem taxes	$449

STEP FOUR - CALCULATE ADDITIONAL PRE-TAX RETURN

2006 PRE-TAX COST OF CAPITAL

As Determined by CPUC in GRC Decision

Capital	Amount (000's)	Percent	Capital Cost	Weighted Cost Rate	Revenue Multiplier	Revenue Requirement Factor
Debt		58.97%	6.36%	3.75%		3.75%
Equity		41.03%	10.00%	4.10%	1.74627	7.16%
Total		100.00%		7.85%		10.92%

4-1-07 SURCHARGE CALCULATION

Eligible Net Additions	$538,373
Less: Accumulated Depreciation On Jan and Feb Additions (2 Months)	2,573
Additional Net Rate Base for 4-1-07 ISRS Calculation	$535,800
Revenue Requirement For Net Rate Base Increase	$58,485
Quarterly Revenue Requirement For Net Rate Base Increase	$14,621
Quarterly Depreciation Expense on Eligible Investments	3,859
Quarterly Ad Valorem Taxes on Eligible Investments	1,346
Total Quarterly ISRS Costs	$19,826
Base Rate Revenue From 4-1-07 to 7-1-07	$4,727,000
ISRS Surcharge To Be Applied To Bills Rendered From 4-1-07 to 7-1-07	0.42%
Impact on a $50 Monthly Bill	$0.21

PROOF OF SERVICE

I, Cinthia A. Velez, declare as follows:

I am employed in the City and County of San Francisco, California. I am over the age of eighteen years and not a party to this action. My business address is STEEFEL, LEVITT & WEISS, One Embarcadero Center, 30th Floor, San Francisco, California 94111-3719. On August 20, 2007, I served the within:

Reply Comments of California-American Water Company on the Alternate Proposed Decision of Commissioner Peevey

on the interested parties in this action addressed as follows:

See attached service list

☒ **(BY HAND SERVICE)** By causing such envelope to be delivered by hand, as addressed by delivering same to SPECIALIZED LEGAL SERVICES with instructions that it be personally served.

☒ **(BY MAIL)** By placing such document(s) in a sealed envelope, with postage thereon fully prepaid for first class mail, for collection and mailing at Steefel, Levitt & Weiss, San Francisco, California following ordinary business practice. I am readily familiar with the practice at Steefel, Levitt & Weiss for collection and processing of correspondence for mailing with the United States Postal Service, said practice being that in the ordinary course of business, correspondence is deposited in the United States Postal Service the same day as it is placed for collection.

☒ **(BY PUC E-MAIL SERVICE)** By transmitting such document(s) electronically from Steefel, Levitt & Weiss, San Francisco, California, to the electronic mail addresses listed above. I am readily familiar with the practices of Steefel, Levitt & Weiss for transmitting documents by electronic mail, said practice being that in the ordinary course of business, such electronic mail is transmitted immediately after such document has been tendered for filing. Said practice also complies with Rule 1.1 of the Public Utilities Commission of the State of California and all protocols described therein.

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that this declaration was executed on August 20, 2007, at San Francisco, California.

Cinthia A. Velez

Cinthia A. Velez

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